Request for Permission to Proceed with a Public Hearing
For Proposed Amendments to
Regulations Sections 24411 and 25106.5-1,
Ordering of Dividend Payments

On February 9, 2005, staff received authorization from the Franchise Tax Board to proceed with a symposium on the proposed amendments to Regulations sections 24411 and 25106.5-1. A symposium to discuss the proposed amendments to the existing regulations was held on April 4, 2005. The proposed amendments to the regulations are in response to an appellate court decision, *Fujitsu It Holdings, Inc. v. Franchise Tax Board* (First App. Dist. 2004) 120 Cal.App. 4th 459. Staff is proposing amendments to Regulations sections 24411(e) and 25106.5-1(f)(2), not to change their substance, but to clarify an example in one of the regulations and to definitively set forth the rule for the ordering of dividends that are paid from income that has been included in a unitary combined report and from income that has not been included in a unitary combined report.

A report on the symposium was included in the materials for the Board meeting of June 15, 2005. Those materials included responses to comments received from the public. At that June 2005 meeting, staff requested permission to proceed to the formal public hearing process. The Board did not authorize staff to proceed at that time, but instead directed staff to provide a report addressing the issue of statutory construction raised by the public during the June 15, 2005, Board meeting. Subsequent to the June 15, 2005, Board meeting Tom Campbell, then Director of the Department of Finance, sent a memorandum to Gerald Goldberg, the former Executive Director of the Franchise Tax Board, expressing support for amending the regulations but suggesting that they should be adopted with a prospective application only. Member Campbell's memorandum was posted on the department's public web site.

Staff's report about the statutory construction questions was provided to the Board at its meeting of September 7, 2005. Staff did not submit a request for Board action at that Board meeting in order to give the Board an opportunity to review staff's analysis and for the public to provide comments. No further comments have been received since that Board meeting. At the September 7, 2005, Board meeting staff was directed to provide an analysis of Member Campbell's memorandum. An analysis was prepared and it was transmitted to the Board members on November 23, 2005.

Subsequent to the September 7, 2005, Board meeting, the California State Board of Equalization (SBE), on November 20, 2006, released its published decision in the *Appeal of Apple Computer, Inc.*, Cal. St. Bd. of Equal., November 20, 2006, 2006-SBE-002 (*Apple*). The year involved in *Apple* was 1989, and involved the same issues that were decided in the *Fujitsu* opinion and that are addressed by the proposed amendments. With respect to the question of whether dividends are distributed on a "last in first out" basis, at page 10 of the *Apple* decision the SBE stated that "*Fujitsu* does not provide any guidance on LIFO ordering." Accordingly, the SBE held that the FTB's use of the LIFO method for ordering the distribution of dividends is appropriate.

With respect to whether dividends should be prorated (the FTB's position in both *Fujitsu* and *Apple*) or distributed under a preferential ordering rule (the taxpayer's position in both *Fujitsu* and *Apple*), at page 13 of the *Apple* decision the SBE stated that: "[a]fter careful consideration, we hold that dividends paid from a mix of included and excluded earnings should be prorated. This holding is consistent with the weight of authority, follows the opinion of the California Supreme Court, respects longstanding administrative practice and has a sound basis in policy and theory." (At page 14 of the *Apple* decision the SBE pointed out that *Safeway Stores v. Franchise Tax Board* (1970) 3 Cal. 3rd 745, which supports the prorating of dividends, was decided by the California Supreme Court while *Fujitsu* was decided by the California Court of Appeal).

Staff now requests permission to proceed to the formal public hearing process under the Administrative Procedure Act. Staff recommends that the proposed amendments be applicable to all years because they are clarifying in nature and such application would be consistent with the SBE's decision in *Apple*.

Copies of all the materials referenced in this request are attached.

Staff Proposed Amendments to Regulation 24411
Additions in <u>Underline</u>
Deletions in ~~Strikethrough~~

(a) Allowance of deduction. Revenue and Taxation Code section 24411 allows taxpayers that have elected to compute their income derived from or attributable to sources within California pursuant to Article 1.5 of Chapter 17 of the Corporation Tax Law a deduction with respect to qualifying dividends. In general, the deduction is an amount equal to 75 percent of such qualifying dividends. However, a deduction in an amount equal to 100 percent is allowed with respect to such qualifying dividends derived from specified construction projects.<u> No deduction is allowable under section 24411 with respect to dividends for which a deduction is allowable or otherwise eliminated from net income under some other provision of the Revenue and Taxation Code.</u>

(b) Definitions.

(1) Qualifying dividends.

(A) "Qualifying dividends" are those dividends received by any member of the water's-edge group from a corporation, the average of whose property, payroll and sales factors within the United States is less than 20 percent and of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group at the time the dividend is received. The dividend payor need not be in a unitary relationship with the recipient of the dividend or any other member of the water's-edge group<u>, and the dividend can be a "qualifying dividend" even if it is paid from earnings and profits from a year before a year for which the water's-edge election was made.</u>~~ A dividend received from a member of the water's edge group may be a qualifying dividend when it is treated as being paid out of earnings which were not included in a combined report with those of the recipient~~. Qualifying dividends shall be classified as business or nonbusiness income pursuant to the rules established in regulations adopted pursuant to Part 11 of the Revenue and Taxation Code. (See Cal. Code Regs., tit. 18, § 25120, sub. (c), and applicable administrative and judicial decisions.)

(B) For purposes of the definition of "qualifying dividends" in Revenue and Taxation Code section 24411, subdivision (a), the term "corporation" shall include banks for taxable years beginning on or after January 1, 1998.

(C) Qualifying dividends do not include amounts deemed to be dividends pursuant to Internal Revenue Code sections 78, 951 et seq., and 1248, or otherwise, unless there is a distribution, actual or constructive, or a provision in the Revenue and Taxation Code requiring that a dividend be deemed to have been received.

(2) United States. For purposes of this section the "United States" means the 50 states of the United States and the District of Columbia.

(3) Water's-edge group. "Water's-edge group," for purposes of the calculations required by Revenue and Taxation Code section 24411, means all banks, corporations or other entities whose income and apportionment factors are considered pursuant to Revenue and Taxation Code section 25110 in computing the income of the individual taxpayer for the current taxable year which is derived from or attributable to sources within this state.

(c) Computation of amount allowable.

(1) In general. The amount of the deduction allowable under Revenue and Taxation Code section 24411 is equal to 100 percent of the qualifying dividends described in ~~Revenue and Taxation Code~~ section 24411, subdivision (c), and 75 percent of other qualifying dividends, to the extent that either class of qualifying dividend is not otherwise ~~allowed~~ allowable as a deduction or eliminated from income.

(2) Dividends deductible under other sections. In no event shall a deduction be allowed with respect to a dividend for which a deduction is allowable ~~has otherwise been allowed~~ (e.g., Revenue and Taxation Code sections 24402 or 24410) or which is ~~has been~~ eliminated from income (e.g., Revenue and Taxation Code section 25106). (See subsection (e) below.)

(d) Dividends derived from construction projects.

(1) General. A deduction in the amount of 100 percent shall be allowed for qualifying dividends derived from construction projects, the locations of which are not subject to the control of the taxpayer. If the payor of the dividend has earnings and profits derived from both construction projects and other activities, the dividend shall be treated as paid from construction projects as described in subsection (d)(5) of this regulation.

(2) Construction project. "Construction project" for purposes of Revenue and Taxation Code section 24411, subdivision (c), means an activity undertaken for an entity, including a governmental entity, which is not affiliated with the water's-edge group, the majority of the cost of performance of which is attributable to an addition to real property or to an alteration of land or any improvement thereto as those terms are defined in the Revenue and Taxation Code and the regulations adopted pursuant thereto.

(A) A "construction project" does not include the operation, rental, leasing or depletion of real property, land or any improvement thereto.

Example: An oil company drills a successful oil well in a foreign country and produces oil. Dividends arising from the production of oil are not derived from a construction project.

(B) For purposes of this subsection (2), an entity is affiliated if it is a member of a commonly controlled group of which a member of the water's-edge group is also a member. (See Cal. Code Regs., tit. 18, § 25110, sub. (b)(2).)

(3) Location not subject to taxpayer's control. A "location is not subject to the taxpayer's control" when the majority of the construction, measured by costs of performance, must be performed at the site in the foreign location because of the nature and character of the project, not because of the terms of the contract.

(4) Examples:

(A) A construction project is undertaken to build a dam. The location is not subject to the taxpayer's control because the dam must be built at a specific site.

(B) A construction project is undertaken to build a skyscraper. The location is not subject to the taxpayer's control because the skyscraper must be built at a specific site.

(C) A construction project is undertaken for the erection of pre-fabricated buildings. The majority of the cost involves pre-fabrication of the components, not their assembly and erection. The components can be pre-fabricated anywhere. The location of the project is under the control of the taxpayer.

(D) An engineering firm designs an oil refinery. The project does not qualify for a deduction under Revenue and Taxation Code section 24411, subdivision (c), because (1) it does not involve construction, and (2) the activity can be conducted anywhere.

(5) Determination of dividends attributable to construction projects the location of which is not subject to the taxpayer's control. For purposes of determining whether dividends are attributable to construction projects the location of which is not subject to the taxpayer's control, dividends shall be considered to be paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits, by year, thereafter. For any year in which the dividend payor has earnings and profits from activities other than construction projects the location of which is not subject to the taxpayer's control, the dividend shall be attributed to construction projects the location of which is not subject to the taxpayer's control in the ratio which the total earnings and profits from construction projects the location of which is not subject to the taxpayer's control bears to the total earnings and profits for the year. For purposes of applying such ratio, earnings and profits attributable to any particular construction project or other activity of the payor of the dividend shall include all costs

and expenses directly attributable to such project or activity as well as an allocable portion of the total other costs and expenses of the payor which are not attributable to a particular project or activity. The total of such other costs and expenses will be allocated among all of the projects and activities of the payor on the basis of their relative gross receipts, or on any other reasonable basis which the payor uses to apportion or allocate such expenses. Following the allocation of all costs and expenses of the payor, any deficit in earnings and profits for any project or activity will be ignored in calculating the ratio referred to above.

Example: Following the allocation of all costs and expenses, the payor has total earnings and profits of $ 150, comprised of earnings and profits of $ 100 each from projects A and B and a deficit of $ 50 for activity C. Of the total earnings and profits of $ 150, $ 75 will be attributable to A and $ 75 to B. No earnings and profits will be attributable to C.

(e) Classification of distributions.

(1) Ordering. For purposes of determining the application of Revenue and Taxation Code sections 24402, 24410, 24411 and 25106 (or any other section of the Revenue and Taxation Code that provides that a dividend is not included in net income), dividends shall be considered to be paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits by year thereafter. (See section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code).) If a dividend is paid out of the earnings and profits of a given year, and the dividend is not sufficient to exhaust the total earnings and profits of that year, the dividend shall be considered a dividend eligible for treatment under Revenue and Taxation Code sections 24402, 24410, 24411, or 25106 (or any other section of the Revenue and Taxation Code that would provide that the dividend is not included in net income), respectively, on a pro rata basis, based on the ratio of earnings and profits drawn from that year to the total earnings and profits originally available to be drawn from that year.

(2) Partially included entities. In the case of an affiliated corporation, a portion of whose net income and apportionment factors are included in a combined report by reference to Revenue and Taxation Code section 25110, subdivision (a), paragraphs (4) or (6), which pays dividends to other members of the taxpayer's water's-edge group, the following rules shall apply:

(A) Dividends shall be considered to be paid out of current earnings and profits to the extent thereof and from the most recently accumulated earnings and profits thereafter. (See section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code).)

(B) Dividends which are considered paid out of earnings and profits of a year in which only a portion of the dividend-paying entity's income and factors were considered in determining the amount of income derived from or attributable to California sources of another entity shall be considered subject to the provisions of Revenue and Taxation Code section 25106, to the extent paid out of that portion of the earnings and profits attributable to income included in the combined report, under the rules provided in subsection (e)(1) of this section.

(3) Subpart F income. For purposes of Revenue and Taxation Code section 25110, subdivision (a), paragraph (6), a portion of the income and apportionment factors of an entity with Subpart F income, as defined in the Internal Revenue Code, is included in the combined report used to determine the income of the water's-edge group derived from or attributable to sources within this state. For purposes of the Internal Revenue Code, Subpart F income is treated as a deemed dividend to the owner of the corporation. This is different from the treatment provided for in Revenue and Taxation Code section 25110. As a consequence, the rules established in the Internal Revenue Code and the regulations adopted pursuant thereto with regard to the classification of distributions from an entity with Subpart F income have no application for purposes of the Corporation Tax Law. The classification of a distribution for an entity that has Subpart F income shall follow the rules set forth in subsections (e)(1) and (2) of this regulation.

(4) Examples:

~~Example 1: Corporation A files a water's edge election which allows it to exclude Corporation C, a foreign incorporated unitary subsidiary with none of its property, payroll, and sales factors within the United States. Corporation C has current earnings and profits of $100 and retained earnings and profits of $100 during years when C was included in the combined report filed by A.~~

~~C declares a dividend of $100. The entire payment is subject to the provisions of Revenue and Taxation Code section 24111.~~

~~C declares a dividend of $150. The dividend is deemed to be paid first our of the current year's earnings and profits of $100. The remaining $50 is paid from accumulated earnings and profits earned in years when C was included in the combined report filed by A.~~

~~A portion of the payment, $100, is subject to the provisions of Revenue and Taxation Code section 24411. The remaining $50 is subject to the provisions of Revenue and Taxation Code section 25106 and is eliminated from A's income.~~

Example 1: Corporation A owns more than 50% of the voting stock of Corporation B, a foreign corporation that had no property, payroll, or sales within the United States. Corporation B was excluded from Corporation A's water's edge group pursuant to a water's-edge election made for the current year. Corporation B had earnings and profits for the current year (Year 2) in the amount of $400, and had earnings and profits of $500 for the immediately preceding year (Year 1). None of the earnings and profits for either year was attributable to a construction project. All dividends drawn from Corporation B's earnings and profits of Year 2 are eligible for the 75% deduction provided by section 24411 of the Revenue and Taxation Code. In Year 1, the water's-edge election was not in place. In Year 1, Corporation B had earnings and profits of $300 attributable to income included in the combined report of Corporations A and B, and dividends drawn from those earnings and profits are eligible for elimination under section 25106 of the Revenue and Taxation Code. The remaining $200 of earnings and profits was not attributable to income included in the combined report of Corporations A and B. Because section 24411 applies only to qualifying dividends not otherwise deductible or eliminated from income, only $200 of dividends paid from the earnings and profits for Year 1 is eligible for the 75% deduction provided by section 24411. During Year 2, Corporation B issued a dividend to Corporation A of $800.

The dividend is first considered drawn from the earnings and profits of the current year, Year 2. Because the current year's earnings and profits are exhausted, the pro rata rule of subsection (e)(1) of this section does not apply to dividends paid from that year. Thus, the entire $400 of dividend paid from Year 2 earnings and profits is eligible for the 75% deduction provided by section 24411. The remaining $400 portion of the dividend ($800 less the $400 drawn from the current year's earnings and profits) is then drawn from the earnings and profits of Year 1. Because the earnings and profits of Year 1 are not exhausted by the dividend paid, the dividend is treated as drawn proportionately from all earnings and profits of that year under subsection (e)(1) of this section. Thus, $240 of the dividend from that year is eliminated from income under section 25106 ($300 eligible for section 25106 treatment times the ratio of the amount drawn from Year 1 ($400) to the original amount available to be drawn from that year ($500)). Dividends of $160 are eligible for the 75% deduction under section 24411 ($200 eligible for section 24411 treatment times the ratio of the amount drawn from Year 1 ($400) to the amount originally available to be drawn from that year ($500)), because section 24411 applies regardless of the year of earnings and profits from which the dividend is paid. The total amount of earnings and profits paid as a dividend that is eligible for the 75% deduction under section 24411 is $560 ($400 from Year 2 and $160 from Year 1). The taxpayer's deduction under section 24411 is $420 ($560 x 75%).

Example 2: Corporation A has filed a water's-edge election effective January 1 ~~1988~~ of Year 1, which would allow it to exclude ~~corporation~~ Corporation F except for the fact Corporation F has Subpart F income that causes Corporation F to be a partially included controlled foreign corporation. The partial inclusion ratio equals Subpart F income of the controlled foreign corporation divided by current earnings and profits. Corporation F has a partial inclusion ratio of ~~66.67%~~80% and total earnings and profits of $150 in ~~1988~~ Year 1. Therefore, ~~$100~~ $120 represents earnings and profits attributable to income ($150 earnings and profits times the ~~x 66.7%~~80% inclusion ratio = ~~$100~~$120) included in the combined report required pursuant to Revenue and Taxation Code section 25110, and dividends paid from those earnings and profits are eligible for elimination under section 25106. In ~~1989~~Year 2, Corporation F has a partial inclusion ratio of ~~50%~~60% and total earnings and profits of $100. Therefore, ~~$50~~$60 represents earnings and profits attributable to income ($100 earnings and profits x ~~50%~~60% inclusion ratio = ~~$50~~$60) included in the combined report required pursuant to Revenue and Taxation Code section 25110, and dividends paid from those earnings and profits are eligible for elimination under section 25106. None of the earnings and profits was attributable to construction projects.

Corporation F declares a dividend of $75 in ~~1989~~Year 2. The distribution is not sufficient to exhaust the $100 of earnings and profits for Year 2 and the pro rata rule of subsection (e)(1) of this section applies. Thus, $45~~$37.50~~ of the dividend ~~for 1989~~paid in Year 2 (~~$50~~$60 eligible for section 25106 treatment x $75/$100) is treated as having been paid from the available ~~$50~~$60 of earnings and profits attributable to income included in the combined report in ~~1989~~Year 2 and is eliminated from income. The remaining $30 portion of the dividend ($40 x $75/$100) is not eligible for elimination under section 25106 but is eligible for the 75% deduction under section 24411.

In summary, Corporation A has dividend income of ~~$37.50~~$45 which is subject to the provisions of Revenue and Taxation Code section 25106 and is therefore eliminated from income and ~~$37.50~~$30 of dividends subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $22.50 ($30 x 75%).

Example 3: Assume the same facts as in Example 2, except that Corporation F declares a dividend of $200 in ~~1989~~Year 2. The distribution exceeds the $100 of earnings and profits for Year 2, and thus the pro rata rule of subsection (e)(1) of this section does not apply to the distributions of that year. Thus, ~~$50~~$60 of the dividend is treated as having been paid from the ~~$50 of~~entire $60 of earnings and profits attributable to income included in the combined report in ~~1989~~Year 2, and ~~$50~~$40 of the dividend is treated as having been paid from the ~~other~~whole of the remaining $40 of earnings and profits that were attributable to income that was not included in the combined report in ~~1989~~Year 2. The remaining $100 ($200 less the $100 earnings and profits drawn from Year 2) is treated as having been paid from ~~1988~~Year 1 earnings and profits. Because the remaining $100 distribution does not exhaust the earnings and profits for Year 1, the pro rata rule of subsection (e)(1) of this section applies. Thus, ~~$66.67~~ $80 of the dividend ($120 x $100/$150) is treated as being paid from earnings and profits attributable to income included in the combined report in ~~1988~~Year 1. ~~and the~~ The remaining ~~$33.33~~$20 ($30 x $100/$150) is from earnings and profits attributable to income that was not included in the combined report in ~~1988~~Year 1, and is eligible for the 75% deduction under section 24411.

In summary, Corporation A has dividend income of ~~$116.67 ($50 (1989) + $66.67 (1988))~~$140 ($60 from Year 2, and $80 from Year 1) which is subject to the provisions of Revenue and Taxation Code section 25106 and is therefore eliminated from income. Corporation A's remaining ~~$83.33 ($50 (1989) + $33.33 (1988))~~$60 ($40 from Year 1 and $20 from Year 2) of dividend income is subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $45

($60 x 75%).

Example 4: Corporation A files a water's-edge election which allows it to include Corporation P, a foreign incorporated unitary subsidiary with less than 20 percent of the average of its property, payroll and sales factors within the United States only to the extent of its United States income and factors. Corporation P has current earnings and profits of $100 of which $10 represents earnings and profits attributable to income included in the water's-edge combined report pursuant to Revenue and Taxation Code section 25110, subdivision (a)(4). None of its earnings and profits is attributable to construction projects.

P declares a dividend of $50~~.~~, which is not sufficient to exhaust the earnings and profits of the current year. Thus, the pro rata rule of subsection (e)(1) of this section applies to the current year's dividend paid . Of ~~such amount~~the dividend paid, $5 ($10 x $50/$100) is subject to elimination under Revenue and Taxation Code section 25106, and $45 ($90 x $50/$100) is subject to the provisions of Revenue and Taxation Code section 24411. Corporation A's deduction under section 24411 is $33.75 ($45 x 75%).

(f) This regulation applies to taxable years beginning on or after January 1, 1996 except as otherwise speicifcally provided.

Staff Proposed Amendments to Regulation § 25106.5-1
(Only those subsections proposed to be amended are set forth)
Additions in Underline
Deletions in ~~Strikethrough~~

(b) Definitions. For purposes of this regulation:

(1) Intercompany transactions.

(A) Except as provided in subsection (b)(1)(B), the term "intercompany transaction" means a transaction between corporations which are members of the same combined reporting group immediately after such transaction. "S" is the member transferring property or providing services, and "B" is the member receiving the property or services. Intercompany transactions include, but are not limited to --

1. S's sale of property (or other transfer, such as an exchange or contribution) to B;

2. S's performance of services for B, and B's payment or accrual of its expenditures for S's performance;

3. S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditures; and

4. S's distribution to B with respect to S stock, to the extent that the distribution is eliminated from income under section 25106 or constitutes a distribution in excess of basis that results in a deferred intercompany stock account (DISA) as described in subsection (f) of this regulation.

5. (B) The term intercompany transaction does not include transactions which produce nonbusiness income or loss to the selling member or income attributable to a separate business activity of the selling member. The term intercompany transaction also does not apply when the asset transferred in the transaction is acquired for the buyer's nonbusiness use or for the use of a separate business activity of the buyer. For purposes of this regulation, such transactions shall be considered as if between corporations that are not members of a combined reporting group.

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(f) Stock of Members.

(1) Unless otherwise provided, this regulation applies the provisions of Treasury Regulation section 1.1502-13(f) relating to stock of members; however, the provisions of subsection (f)(6) of that section shall not apply.

(A) Exception for distributee member. Treasury Regulation section 1.1502-13(f)(2)(ii) shall not apply to exclude intercompany distributions from the gross income of the distributee member. Intercompany dividend distributions described by section 301(c)(1) of the Internal Revenue Code are included in the income of the distributee member unless subject to elimination or deduction under other applicable law, including sections 25106 or 24402 of the Revenue and Taxation Code. The treatment of intercompany distributions described by section 301(c)(3) of the Internal Revenue Code is provided by subsection (f)(1)(B) of this regulation.

(B) Deferred intercompany stock account (DISA). That portion of an intercompany distribution which exceeds California earnings and profits and P's basis in S's stock (the portion of a distribution described by section 301(c)(3) of the Internal Revenue Code) will create a DISA. In this subsection, P is treated like the Buyer (B) for purposes of calculating corresponding and recomputed items.

The DISA will be treated as deferred income. To the extent of a sale, liquidation or any other disposition of shares of the stock, the balance of the DISA with respect to such shares will be taken into account as income or gain to P even if S and P remain members of the same combined reporting group. The disposition shall be treated as a sale or exchange for purposes of determining the character of the DISA income or gain. The DISA is held by the distributee.

1. A disposition of all the shares shall be deemed to have occurred if either S or P becomes a non-member of the combined reporting group or if the stock of S becomes worthless.

2. Because P's DISA is deferred income and not negative basis, the DISA is taken into account upon liquidation, including complete liquidation into the parent. The deferred income restored as a result of the liquidation will be taken into account ratably over 60 months unless the taxpayer elects to take the income into account in full in the year of liquidation. For example, if S liquidates and the exchange of P's S stock is subject to section 332 of the Internal Revenue Code (section 24451 of the Revenue and Taxation Code), P's DISA income taken into account under subsection (f)(1)(B) of this regulation is recognized over 60 months, unless an election is made to recognize the deferred income in the year of liquidation. Nonrecognition or deferral shall not apply to DISA income or gain taken into account as a result of an event described in subsection (f)(1)(B)1. of this regulation.

3. If P transfers the stock of S to another member of the combined reporting group, P's DISA income will be an intercompany item and deferred under the rules of this regulation.

4. If, on the effective date of this regulation, a closing agreement has been executed with the Franchise Tax Board to defer income from distributions described under section 301(c)(3) of the Internal Revenue Code, then such income shall be included in the DISA of the distributee member to the extent that it has not already been taken into account in the income of the distributee member. Thereafter, the balance of the DISA account shall be taken into account under the rules of this regulation.

5. If P receives an intercompany distribution described by section 301(c)(3) of the Internal Revenue Code in an income year beginning prior to the effective date of this regulation, the taxpayer may request a closing agreement under section 19441 of the Revenue and Taxation Code that will allow the gain from the distribution to be deferred in a manner consistent with the provisions of subsection (f)(1)(B) of this regulation. The request shall be mailed within one year after the effective date of this regulation and within the applicable statutes of limitations on deficiency assessments or refund claims for the year of the distribution. The request shall describe the parties to the transaction, including federal identification numbers, the nature of the distribution, the timing and amounts of the income involved, and any other relevant facts. Requests shall be mailed to the following address: California Franchise Tax Board, Legal Branch, Attn: Chief Counsel, P.O. Box 1720, Rancho Cordova, CA 95741-1720.

(2) Examples. The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1: Dividend exclusion and property distribution.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 1.)

Facts. On December 31 of Year 1, S had accumulated earnings and profits of $480, and in Year 2, S had an additional $20 in earnings and profits. The earnings and profits from both years were attributable to business income included in the combined report that included S and its parent corporation P and eligible for elimination under section 25106 of the Revenue and Taxation Code. In Year 3, S owns land that is used in the trade or business of the combined reporting group with a $ 70 basis and $ 100 value. ~~On January 1 of Year 1,~~ P's basis in S's stock is $ 100 ~~and S has accumulated earnings and profits of $500 from prior year's combined reports of S and P.~~ During ~~Year 1~~ Year 3, S declares and makes a dividend distribution of the land to P. P also uses the land in the unitary business. S has no earnings and profits from its ordinary business operations in Year 3. Under section 311(b) of the Internal Revenue Code, S has a $ 30 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the land is $ 100. (California law generally conforms to Internal Revenue Code sections 301-385 under section 24451 of the Revenue and Taxation Code.) On July 1 of Year ~~3~~ 4, P sells the land to Y for $ 110.

Dividend treatment. S's distribution of the land is an intercompany distribution to P in the amount of $ 100. Under subsection (j)(4) of this section, the $30 of intercompany gain is not reflected in the earnings and profits of S in Year 3. Instead, that amount is reflected in the earnings and profits of S in Year 4, the year of the sale of the land to Y. Under section 316 of the Internal Revenue Code (applicable for purposes of Part 11 of the Revenue and Taxation Code pursuant to section 24451 of the Revenue and Taxation Code), earnings and profits are first paid from current earnings and profits, and then from earnings and profits of the most recent year of accumulation. Because S had no earnings and profits in Year 3, the distribution in Year 3 is first paid out of Year 2 earnings and profits of S~~,~~ (to the extent of the available $20) and then the remaining $80 (the $100 distribution less the $20 drawn from Year 2) is paid out of the available $480 of earnings and profits of Year 1. Because the entire earnings and profits of both years ~~which~~ are attributable to income that has ~~have~~ been included in a combined report of S and P, the entire $100 dividend ~~it~~ will be eliminated from P's income pursuant to section 25106 of the Revenue and Taxation Code. The payment of the dividend has no effect on P's $100 basis in the stock of S.

Matching rule. Under the matching rule (treating P as the buying member and S as the selling member), S takes its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain ($ 110-$ 100 basis in the land) and the $ 40 recomputed gain ($ 110 - $ 70 basis that the land would have had if S and P were divisions).

Apportionment. ~~The~~Because the entire amount is eliminated from income under section 25106, the intercompany distribution is not reflected in the sales factor in Year ~~1~~3. In Year ~~3~~ 4, unless otherwise excluded, the $ 110 gross receipts from P's sale of the land to Y will be included in P's sales factor. After the distribution in Year ~~1~~3, the land will be included in P's property factor at S's $ 70 original cost basis. Both S's $ 30 gain and P's $ 10 gain relative to the distributed land will be treated as current apportionable business income in Year ~~3~~4.

Example 2: Dividends paid from ~~pre-unitary~~ earnings and profits not included in a combined report.

Facts. The facts are the same as in Example 1 except that only $300 of S's $480 earnings and profits from Year 1 were attributable to income included in a ~~prior~~combined report that included S and P, and thus eligible for elimination under section 25106 of the Revenue and Taxation Code. ~~is only $10 S also has $490 of earnings and profits that arose in years before a unitary relationship existed between S and P.~~

Dividend treatment. Because ~~only $10~~ $20 of S's distribution was paid from earnings and profits attributable to Year 2 business income that was wholly included in a combined report of S and P, ~~only~~ the entire ~~$10~~$20 amount is eliminated under section 25106 of the Revenue and Taxation Code. The remaining $ ~~90~~ 80 of the dividend ~~will be taken into account by P in Year 1~~ is treated as proportionately paid from the whole of the original earnings and profits of Year 1, the next most recent year of accumulation, including both earnings and profits that were attributable to S and P's combined report and those that were not. Thus, $50 ($300 combined report earnings and profits multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total originally available earnings and profits of Year 1) is treated as eliminated under section 25106 of the Revenue and Taxation Code. The remaining $30 paid from earnings and profits of Year 1 ($180 earnings and profits not eligible for elimination under section 25106 multiplied by the ratio of $80 (the remaining amount of the dividend, drawn from Year 1) to $480 (the total earnings and profits of Year 1)) is taxable, subject to any applicable deductions under Revenue and Taxation Code sections 24402, 24410, ~~or~~ 24411 or any other section of the Revenue and Taxation Code that provides that the dividend not included in net income ~~of the Revenue and Taxation Code~~. (See California Code of Regulations, title 18, section 24411, subsection (e) for rules relating to the treatment of distributions that include both earnings and profits eligible for elimination under section 25106 of the Revenue and Taxation Code, and those eligible for deduction under sections 24402, 24410, and 24411 or any other provision of the Revenue and Taxation Code.)

Matching rule. P's corresponding item is not its dividend income, but its income, gain, deduction or loss from the property acquired in the intercompany distribution. Therefore, none of S's intercompany gain will be taken into account in Year ~~1~~3. As in Example 1, S will take its $ 30 intercompany gain into account in Year ~~3~~4 to reflect the $ 30 difference between P's $ 10 corresponding gain and the $ 40 recomputed gain.

Apportionment. The apportionment results are the same as in Example 1, except that to the extent that the Year ~~1~~3 dividend is not eliminated under section 25106 or ~~deducted~~deductible under sections 24402, 24110, ~~or~~ 24411 or any other provision of the Revenue and Taxation Code, P's dividend income will be treated as current apportionable business income in Year ~~1~~3. The intercompany distribution is not included in the sales factor in Year ~~1~~3, to the extent attributable to dividends eliminated from income under section 25106.

Example 3: Deferred intercompany stock accounts.

(Refer to Treas. Reg. § 1.1502-13(f)(7), example 2.)

Facts. S owns all of T's stock with a $ 10 basis and $ 100 value. S has substantial earnings and profits which are attributable to business income included in a combined report of S, T and P. T has $ 10 of accumulated earnings and profits, all of which are attributable to business income included in a combined report of S, T and P. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b) of the Internal Revenue Code, S has a $ 90 gain. Under section 301(d) of the Internal Revenue Code, P's basis in the T stock is $ 100. During Year 3, T borrows $ 90 from an unrelated party and declares and makes a $ 90 distribution to P to which section 301 of the Internal Revenue Code applies. During Year 6, T has $ 5 of current earnings which is attributable to business income included in the combined report of S, T and P. On December 1 of Year 9, T issues additional stock to Y and, as a result, T becomes a nonmember.

Dividend elimination. P's $ 100 of dividend income from S's distribution of the T stock, and its $ 10 dividend income from T's $ 90 distribution, are eliminated from income under section 25106 of the Revenue and Taxation Code.

Matching and acceleration rules. P has no deferred intercompany stock account (DISA) with respect to T stock because T's $ 90 distribution did not exceed T's $ 10 of earnings and profits and $ 100 stock basis. Therefore, P's corresponding item in Year 9 when T becomes a nonmember is $ 0. Treating S and P as divisions of a single corporation, the T stock would continue to have a $ 10 basis after the distribution from S to P. T's $ 90 distribution in Year 3 would first reduce T's $ 10 earnings and profits to zero, then reduce the $ 10 recomputed basis in T stock to zero and create a $ 70 recomputed DISA. T's $ 5 of earnings in Year 6 does not affect the amount of the DISA. Because the recomputed DISA would be taken into account upon T becoming a nonmember in Year 9, P will have a $ 70 recomputed corresponding item. Under the matching rule, S takes $ 70 of its intercompany gain into account in Year 9 to reflect the difference between P's $ 0 corresponding gain and the $ 70 recomputed gain. S's remaining $ 20 of gain will be taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember or if the stock of T becomes a nonbusiness asset.)

Apportionment. Neither the distributions in Years 1 and 3, nor T becoming a nonmember in Year 9, have any effect on the sales factor. S's $ 70 intercompany gain will be treated as current apportionable business income in Year 9.

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**FORMAL OPINION**
	2006-SBE-002
APPLE COMPUTER, INC.	Case No. 152016

Representing the Parties:

For Appellant:	Christopher Whitney Barry Weissman
For Respondent:	John Su, Tax Counsel III
Counsel for the Board of Equalization:	Ian C. Foster, Tax Counsel

I. <u>Introduction</u>

This appeal is made pursuant to section 19045[1], of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Apple Computer, Inc. against a proposed assessment of additional franchise tax in the amount of $1,258,506 for the year ended September 30, 1989.[2] The issue presented in this appeal is the proper treatment of dividends received from controlled foreign corporations that are partially included in appellant's water's-edge combined report.

For the reasons set forth in this opinion, we conclude that to the extent dividends are paid from the issuing corporation's accumulated earnings, they are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings,

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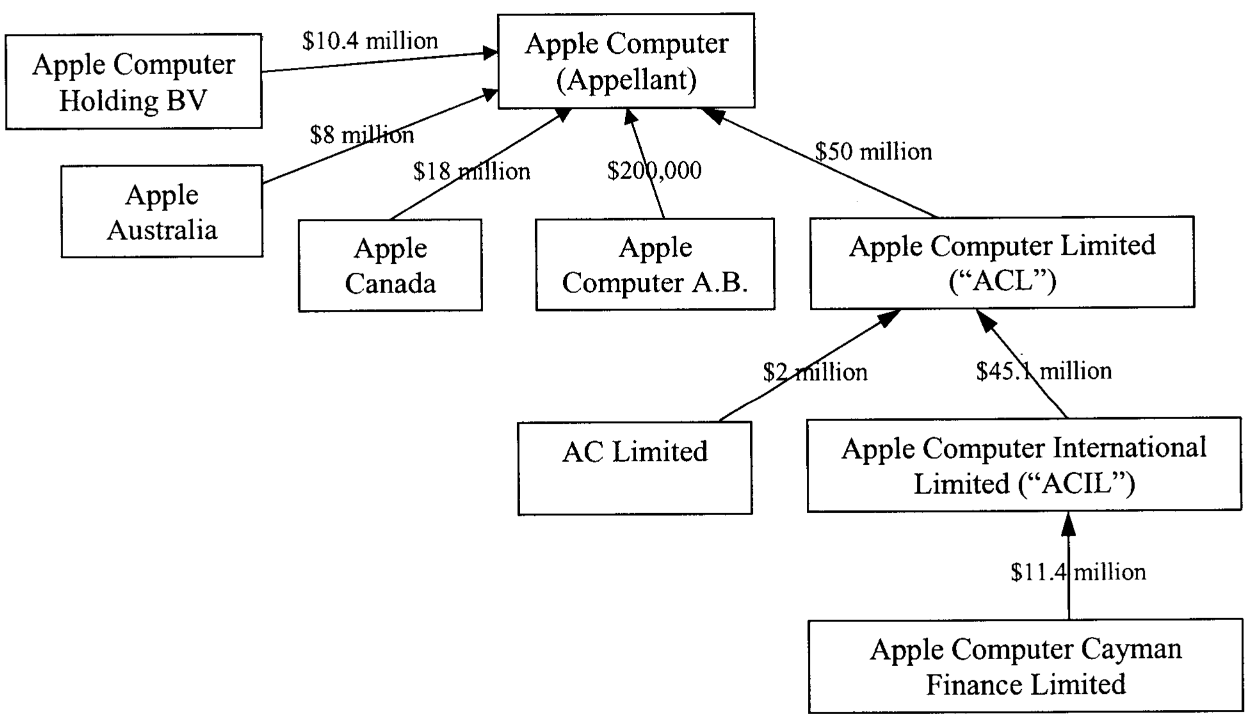
[1] Unless otherwise specified, all references to a "section" or "sections" are to sections of the Revenue and Taxation Code, and all references to a "regulation" or "regulations" are to title 18 of the California Code of Regulations.

[2] $1,258,506 was the amount at issue when appellant initially filed this appeal. The parties have since resolved most of the original issues and the amount at issue is reduced to $231,038.

exhausting each year's earnings in turn. We further conclude that to the extent dividends are paid from a year in which the issuing corporation is partially included in the water's-edge combined report, they are deemed paid from "included income" and "excluded income" in the ratio that included and excluded income bear to total income. (See definitions of "included income" and "excluded income," at footnote 3, *infra.*)

II. **Factual and Procedural Background**

Appellant is a domestic corporation headquartered in Cupertino, California, that develops, manufactures, and sells personal computers and software to a variety of customers in the United States and abroad. Appellant has several wholly-owned foreign subsidiaries from which it received dividends. The parties agree that each relevant subsidiary is a controlled foreign corporation ("CFC") for purposes of Internal Revenue Code ("IRC") sections 951 through 964 ("Subpart F"). The following chart illustrates the corporate relationships and the amounts of dividends paid from and between appellant's subsidiaries:



Through the year ended September 30, 1988, appellant had filed its California returns on a worldwide combined reporting basis. Beginning with the year ended September 30, 1989, appellant elected to file its California returns on a water's-edge basis. Under the water's-edge rules, appellant's CFC's were required to be partially included in the combined report based on their ratios of Subpart F income to total earnings and profits. Appellant determined that the dividends received by ACL and ACIL were not Subpart F income and they should be excluded from the numerator of those companies' inclusion ratios. The result was to include a relatively smaller portion of ACL and ACIL in the water's-edge combined report. Appellant also treated the dividends that it received as paid from income that was included in the combined report, to the extent of that income, and any excess as being paid from income that was excluded from the combined report.[3] The result was to eliminate the dividends received from partially included foreign subsidiaries from appellant's income.

Upon audit, respondent determined that the dividends received by ACL and ACIL were Subpart F income and they should be added to the numerator of those companies' inclusion ratios. Respondent also determined that the dividends received by appellant should be treated as being paid from the current year's earnings first and the most recent years' earnings thereafter; then, dividends paid from any given year should be deemed paid in part from included income and in part from excluded income on a prorated basis. Respondent's adjustments resulted in a larger portion of ACL and ACIL being included in the water's-edge combined report and a smaller portion of the dividends received by appellant being eliminated from income. Accordingly, respondent issued a Notice of Proposed Assessment ("NPA") proposing additional tax due of $1,875,442. Appellant protested the NPA and, upon further review, respondent reduced the assessment (for reasons not relevant here), then affirmed an amount of $1,258,506. Appellant then filed this timely appeal.

This appeal was deferred for approximately three years pending the outcome of litigation that both parties agreed was highly relevant and possibly controlling. That litigation was resolved when the Court of Appeals issued an opinion in *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459 ("*Fujitsu*").[4] As relevant here, *Fujitsu* held that dividends received by an upper-tier

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[3] Hereinafter, we will refer to income that was included in the water's edge combined report as "included income." Likewise, we will refer to income that was excluded from the water's edge combined report as "excluded income."

[4] Amdahl Corporation commenced the litigation, then later changed its name to Fujitsu IT Holdings. In the opinion, the court referred to the taxpayer as Amdahl, as it was known during the years at issue.

foreign subsidiary from a lower-tier foreign subsidiary are not Subpart F income and, therefore, such dividends should be excluded from the inclusion ratio. (*Id.*, at p. 478.) Pursuant to that holding, respondent concedes that dividends received by ACL and ACIL should be excluded from the numerator of those companies' inclusion ratios. Also as relevant here, *Fujitsu* held that dividends paid to a domestic parent from a partially included foreign subsidiary's current earnings should be treated as being paid first out of income that was included in the combined report, with any excess being paid from excluded income. (*Id.*, at p. 480.) In this case, however, respondent continues to maintain that dividends should be prorated between included and excluded income.

III. The Underlying Statutory Framework

In order to aid in the understanding of the issues in this appeal, as well as our resolution of those issues, we believe it is useful to review the underlying statutory framework.

A corporation that is engaged in a unitary business generally must determine its California tax liability based upon a worldwide combined report that includes the income and apportionment factors of all members of the unitary group, wherever located. (Rev. & Tax. Code, §§ 25101 & 25120 – 25137.) However, a corporation may elect to file a water's-edge combined report that includes only those entities that are incorporated in the United States and other specified entities with sufficient connections to the United States. (Rev. & Tax. Code, § 25110.)

If a taxpayer files a water's-edge combined report, the report must include a CFC that has Subpart F income. (Rev. & Tax. Code, § 25110, subd. (a)(7).)[5] California incorporates the federal definitions of a "controlled foreign corporation" and "Subpart F income." (Rev. & Tax. Code, § 25110, subd. (a)(7); Int.Rev. Code, §§ 951 - 964.) The "Subpart F" provisions in the Internal Revenue Code were enacted "to deter taxpayers from using foreign subsidiary corporations to accumulate earnings in countries that impose no taxes on accumulated earnings" and the provisions thereby "eliminate the tax deferral benefits of the undistributed income earned by the CFC." (*R.E. Dietz Corp. v. United States* (2nd Cir. 1991) 939 F.2d 1, 6.) Likewise, California requires the inclusion of a CFC with Subpart F

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[5] During the year at issue, the provision requiring partial inclusion of a CFC with Subpart F income was located in subdivision (a)(7) of section 25110. That provision is now located in subdivision (a)(6) and remains substantially unchanged.

income, which otherwise would have escaped taxation in a foreign country, in the water's-edge combined report. (*Fujitsu, supra*, 120 Cal.App.4th at p. 469.)

A CFC with Subpart F income is not included in its entirety in the water's-edge combined report, but rather is included only to the extent that its business activity results in Subpart F income. To this end, the CFC's income and apportionment factors are multiplied by an "inclusion ratio," the numerator of which is the CFC's Subpart F income and the denominator of which is the CFC's total earnings and profits. (Rev. & Tax. Code, § 25110, subd. (a)(7).)

Section 25106 provides that dividends paid from one member of a unitary group to another member of the group are eliminated from the recipient's income if the dividends are paid from income that was already included in the combined report. Section 24402, as relevant here, provides a 100 percent deduction for dividends that are paid from income that was subject to California tax (regardless of whether the issuing corporation is a member of the recipient's unitary group). Section 24411, as relevant here, provides a 75 percent deduction for dividends that are paid by a member of the recipient's water's-edge group if those dividends are not otherwise eliminated or deducted under sections 25106 or 24402.

As indicated above, the instant appeal involves dividends paid by CFC's that are partially included in appellant's water's-edge combined report. Such dividends were paid from income that had accumulated over several years and that was, in the water's-edge year, partially included in the combined report. To the extent those dividends were paid from included income, they are subject to complete elimination under section 25106, and to the extent those dividends were paid from excluded income, they are subject to the 75 percent deduction under section 24411. However, after this appeal was filed, the Court of Appeals struck down section 24402 as unconstitutional because it facially discriminates against corporations that are not doing business in California. (*Farmer Bros. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976 ["*Farmer Bros.*"].) Respondent's forward-looking remedy is to no longer enforce the unconstitutional statute; that is, respondent no longer allows any deduction under section 24402.[6] (Rev. & Tax. Code, § 19393.) Respondent's backward-looking remedy is to allow the

[6] The forward-looking remedy applies to tax years ending on or after December 1, 1999, as those years were still open to assessment at the time of the *Farmer Bros.* decision. (See Rev. & Tax. Code, § 19057.)

section 24402 deduction for dividends received in earlier years, regardless of whether the dividend-issuing corporation was doing business in California. (Cf. *Ceridian Corp. v. Franchise Tax Board* (2000), 85 Cal.App.4th 875, 888-889.) In this way, no taxpayer is advantaged or disadvantaged by the *Farmer Bros.* decision. Respondent's backward-looking relief, applied here, was to allow section 24402 deductions for dividends received from appellant's foreign subsidiaries. Therefore, in light of *Farmer Bros.*, the dividends that appellant received from its partially included CFC's are, to the extent paid from included income, eliminated under section 25106, and, to the extent paid from excluded income, deducted under section 24402.

In this case we are faced with dividends paid from earnings that had accumulated over several years, some of which were worldwide combined reporting years, but the most recent of which was a water's-edge combined reporting year. Our task is to determine how to allocate dividends among the various years and, when allocated to a water's-edge reporting year, how to allocate the dividends among included and excluded income.[7]

IV. Last-In-First-Out Ordering

The parties appear to agree that the relevant law requires last-in-first-out ("LIFO") ordering with respect to dividends paid from accumulated earnings. They disagree on the mechanics of applying LIFO ordering in practice.

A. Applicable Law

Except as otherwise provided, California generally incorporates the provisions of IRC section 316. (Rev. & Tax. Code, § 24451.) IRC section 316(a) provides that dividends paid from accumulated earnings are deemed paid from the most recently accumulated earnings. Congress enacted LIFO ordering to deter abuse by preventing the issuing corporation from declaring what year's earnings

[7] At first glance, sections 25106 and 24402 seem to have a distinction without a difference; in effect, they both ensure that the entire dividend is excluded from the recipient's taxable income. However, the material difference arises in the context of section 24425, which disallows deductions for expenses that are allocable to items of income that are not included in the measure of tax. The California Supreme Court has determined that section 24425 disallows expenses allocable to dividends deducted under section 24402. (*Great Western Finanical Corp. v. Franchise Tax Board* (1971) 4 Cal.3d 1.) Section 24425 does not apply to expenses that are allocable to dividends eliminated by section 25106. Therefore, appellant may not deduct expenses allocable to dividends deducted under section 24402, while it may deduct expenses allocable to dividends eliminated under section 25106.

were being distributed. (*Edwards v. Douglas* (1925) 269 U.S. 204, 216.) During the year at issue, regulation 24411, subdivision (i)(2)(A), set forth the following rule with respect to dividends received from a partially included CFC:[8]

> "Dividends shall be considered to be paid out of current earnings and profits to the extent thereof and from the most recently accumulated earning and profits thereafter."

The plain language of both IRC section 316(a) and regulation 24411 require LIFO ordering. However, the parties disagree on the mechanics of LIFO ordering.

B. Contentions

Appellant contends that LIFO ordering is satisfied by allocating dividends to the current year's included income to the extent thereof, then to the most recent year's included income, and so on, until all of the accumulated included income is exhausted. Then, any excess dividends can be allocated to excluded income in the same manner. Appellant argues that its interpretation of LIFO ordering is required by *Fujitsu* and section 25106. Appellant notes that the *Fujitsu* court did not simply require that dividends be deemed paid first from included income; the court also emphasized that the plain language and purpose of section 25106 allows members of a unitary group to move dividends among themselves without taxation, and stated that only its method of allocating dividends would effectuate that purpose. (*Fujitsu*, 120 Cal.App.4th at pp. 477-480.)

Respondent contends that LIFO ordering is satisfied only by allocating dividends in such a way that exhausts each year's earnings in turn, without regard to whether the income is included or excluded. Respondent contends that its interpretation is required by the plain language of IRC section 316(a) and regulation 24411.

C. Discussion

We agree with respondent's interpretation of LIFO ordering. IRC section 316(a) and regulation 24411 do not differentiate between different kinds of income; they state that dividends are deemed distributed from more recent earnings before older earnings, without regard to whether the underlying income is included or excluded. Appellant's interpretation does the opposite, deeming

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[8] The relevant language in regulation 24411 is now found in subdivisions (e)(1) and (e)(2)(B).

dividends distributed from included income first, without regard to the year in which the income was earned. In so doing, appellant's interpretation would render meaningless the statutory and regulatory references to "current" and "most recent" earnings.

Appellant's reliance on *Fujitsu* is misplaced because that court did discuss LIFO ordering. In fact, in its holding on allocating dividends, the court stated:

> "We conclude that dividends paid by first-tier subsidiaries <u>from current year earnings</u> should be treated as paid (1) first out of earnings eligible for elimination under section 25106, with (2) any excess paid out of earnings eligible for partial deduction under section 24411." (*Fujitsu*, 120 Cal.App.4th at p. 480 [emphasis added].)

The court's holding expressly applies to dividends paid "from current year earnings." The court made no mention of how to treat accumulated earnings. Accordingly, *Fujitsu* does not provide any guidance on LIFO ordering and does not support appellant's position. Appellant's reliance on section 25106 is also misplaced. Section 25106 merely provides that dividends paid from included income are eliminated from the recipient's income, but it does not address the method for determining whether dividends are paid from included income in the first place. Moreover, appellant's interpretation of LIFO ordering would defeat the original purpose of LIFO, which is to prevent the corporation from choosing which year's earnings it wants to distribute for tax purposes.

For the foregoing reasons, we conclude that IRC section 316(a) and regulation 24411 require LIFO ordering with respect to dividends paid from accumulated earnings. We further conclude that, in order to comply with LIFO ordering, the dividends are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings, exhausting each year's earnings in turn, without regard to whether the earnings represent included or excluded income.

V. <u>Preferential Ordering vs. Prorating</u>

After the application of LIFO ordering determines what portion of the dividends are paid from any given year's earnings, the issue becomes the allocation of dividends paid from a year in which the underlying income was partially included in the combined report. There are two competing methods for determining whether dividends received from a partially included CFC are paid out of included income, excluded income, or some combination thereof. For the sake of consistency and ease of reference, we will refer to those methods as "preferential ordering" and "prorating."

Preferential ordering (advocated by appellant) would deem the dividends to be paid first from included income, to the extent thereof, and any excess to be paid from excluded income. Prorating (advocated by respondent) would deem the dividends to be paid in part from included income and in part from excluded income, in the ratio that included and excluded income bear to total income. Preferential ordering would subject a greater portion of the dividends to complete elimination under section 25106, while prorating would subject a greater portion of the dividends to deduction under sections 24402 or 24411.

A. Applicable Law

Where dividends are paid from income with a mixed character, such as income that is partially sourced in California or partially included in a combined report, respondent's consistent administrative practice since the 1940's has been the use of prorating. In 1958, respondent issued Legal Ruling 211 and promulgated regulation 24402, both of which require prorating. In 1970, the California Supreme Court endorsed respondent's use of prorating in *Safeway Stores v. Franchise Tax Board* (1970) 3 Cal.3rd 745 ("*Safeway*"). In 1989, respondent promulgated regulation 24411, which contained a clear requirement for prorating in subdivision (i)(2)(B):

> "(B) Dividends which are considered paid out of earnings of a year in which a portion of the dividend-paying entity's income and factors were considered in determining the amount of income derived from or attributable to California sources of another entity shall be considered subject to the provisions of Sections 24402, 24410, and 25106 of the Revenue and Taxation Code <u>based upon the ratio of the income included by reference to [the CFC inclusion ratio] to the total earnings and profits … of the entity for the year</u>." (Emphasis added.)[9]

Regulation 24411 also contained examples, in subdivision (i)(4), that applied prorating to hypothetical fact patterns.[10]

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[9] The above-quoted version of regulation 24411 is the version applicable to the year at issue in this appeal. The current version of the relevant language is now found in subdivision (e)(2)(B).

[10] The relevant examples in regulation 24411 are now found in subdivision (e)(4).

In 2004, *Fujitsu* became the first authority to require preferential ordering. The *Fujitsu* court agreed that regulation 24411 requires prorating, but it construed an example in regulation 25106.5-1, subdivision (f)(2), as requiring preferential ordering.[11] Perceiving a conflict in the regulations, the court stated that there was an "absence of clear and controlling guidance" and that it would construe the regulations in favor of the taxpayer and in harmony with the underlying statutes. (*Fujitsu IT Holdings, supra*, 120 Cal.App.4th at p. 480.) The court then held that dividends should be deemed paid "first out of earnings eligible for elimination under section 25106," i.e., included income, with "any excess paid out of earnings eligible for partial deduction under section 24411," i.e., excluded income. (*Id.*)

B. Contentions

Appellant contends that *Fujitsu* is controlling authority and, therefore, the dividends paid by appellant's CFC's should be deemed paid first out of earnings that were included in the combined report and eliminated from income under section 25106. Appellant points out that this appeal was deferred at the request of both parties to await a decision in *Fujitsu* and that respondent repeatedly acknowledged the possible controlling effect of *Fujitsu*.

Appellant argues that *Fujitsu* was not based merely on regulatory interpretation, but also relied on section 25106 and the legislative intent embodied therein. Appellant emphasizes the court's reliance on the purpose of section 25106, where it stated at page 480:

> "In the case of a CFC that is *partially* included in a unitary group, the CFC will be able to move amounts that have been included in the combined income of the unitary group without tax incident only by adopting the ordering rule described above." (Italics in original.)

Appellant contends that regulation 24411, to the extent it requires prorating, is inconsistent with the statutory authority discussed in *Fujitsu*. Appellant argues that when respondent's administrative guidance is inconsistent, unsupported by statutory authority, or violates the intent of the underlying statute, the taxpayer's reasonable interpretation should be respected. According to appellant, that is exactly the position taken by the *Fujitsu* court.

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[11] We are puzzled by the *Fujitsu* court's reliance on regulation 25106.5-1. The relevant example in subdivision (f)(2) deals with LIFO ordering for dividends paid from accumulated earnings; it does not provide for the preferential ordering of dividends paid from a partial inclusion year. Moreover, subdivision (k) of that regulation clarifies that the regulation was not effective until 2001, long after the years at issue in *Fujitsu*.

Further, appellant contends that section 24411 creates a preferential ordering rule for dividends paid from mixed earnings. Section 24411, subdivision (a), allows the 75 percent deduction "to the extent not otherwise allowed as a deduction or eliminated from income." Appellant argues that the quoted language creates an ordering rule because it allows a deduction only to the extent that the dividend was not otherwise eliminated under section 25106. Appellant asserts that its interpretation of section 24411 is not only reasonable, but is the best interpretation of that section in light of its plain language and in light of the purpose of section 25106, which is to prevent double taxation of dividends.

Finally, appellant argues that regulation 24402 and *Safeway* are inapplicable because they discuss the prorating of dividends paid from income that is partially sourced to California, not income that is partially included in a combined report. Appellant argues that the enacting of section 25106 and UDITPA[12] overruled *Safeway* and created a new statutory scheme that limits the usefulness of any authority decided under the old scheme.

Respondent contends that regulation 24411 clearly requires prorating dividends when they are paid from a mix of included and excluded earnings. Respondent states that the prorating of dividends under regulation 24411 is consistent with other California law, including regulation 24402 and the California Supreme Court's endorsement of prorating in *Safeway*. Respondent states that both its approach and appellant's approach will prevent double-taxation of dividends; the difference is the timing of the deduction and the allowance of expenses.

Respondent argues that *Fujitsu* is irrelevant and therefore not controlling here. In this regard, respondent points out that *Fujitsu* discussed allocating dividends between elimination under section 25106 and deduction under section <u>24411</u>. However, respondent states that the dividends at issue in this appeal must be allocated between section 25106 and section <u>24402</u>. Because *Fujitsu* never discussed how the allocation works when the dividends are eligible for deduction under section 24402, respondent argues that *Fujitsu's* holding is not relevant to this appeal.

Respondent further argues that, even if *Fujitsu* is relevant, the holding in *Fujitsu* should not be followed because several components of its reasoning were erroneous. First, regulation 24411, as

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[12] UDITPA is the Uniform Division of Income for Tax Purposes Act. (Rev. & Tax. Code, §§ 25120–25137.)

it read during the year at issue in this appeal (and the years at issue in *Fujitsu*) required prorating of dividends and contained examples that applied the prorating method. Second, regulation 25106.5-1, which the court cited as requiring preferential ordering, was by its own terms not applicable to the years at issue in *Fujitsu* or the year at issue in this appeal. (See footnote 11, *supra.*) Third, regulation 25106.5-1 does not in fact require preferential ordering; the example cited by the court was actually an example of LIFO ordering for dividends paid from accumulated earnings. Because of the court's erroneous reasoning, respondent asks this Board to treat *Fujitsu* with limited deference.

C. Discussion

At the outset, we are not persuaded by the parties' attempts to distinguish the authorities that do not support their respective positions. Appellant correctly states that regulation 24402 requires prorating in the context of dividends paid from income that is partially sourced to California, rather than income that is partially included in a combined report. However, both situations require the allocation of dividends paid from income that has a mixed character, and we see no theoretical reason for applying different allocation methods to substantially similar situations. Moreover, regulation 24402 requires prorating when dividends are partially subject to the section 24402 deduction, which is the case in this appeal. Appellant's attempt to distinguish *Safeway* also fails. We note the *Safeway* Court's description of the facts under its consideration at page 753:

> "[I]f the subsidiaries do business both within and without California, or have <u>nonoperating income or other income not related to the unitary business and therefore not included in the total unitary operating income to which the formula apportionment applied</u>, then the computation of the [predecessor to section 24402] dividend adjustment becomes more complex. When, as in the present case, the adjustments relate to a large multicorporate grocery chain which operates through a series of subsidiaries, . . . some of which do business both within and without California <u>and have nonunitary as well as unitary income</u>, then the computations grow quite involved." (Emphasis added.)

As the above-quoted language indicates, the dividends at issue in *Safeway* were not merely paid from income that was partially sourced to California, but also from income that was partially included in the combined report, which is the situation in this appeal. Additionally, appellant's argument that section 25106 and UDITPA overruled *Safeway*'s endorsement of prorating is not correct. Safeway had two holdings: first, there was no deduction for dividends paid from non-California-source income, even though such income might have been included in the combined report; second, prorating was the proper method to allocate dividends among different types of income. (*Safeway, supra*, 3 Cal.3d at pp. 749-754.) Section 25106 overruled the first holding in *Safeway*, but not the second, which is the relevant holding here.[13] Likewise, any change in the business/nonbusiness character of dividends under UDITPA did not affect the rationale behind prorating. Certainly *Safeway* was decided under a prior statutory scheme, but the prorating method endorsed by the Court was not dependent upon whether, or how, any particular amount would be taxed once it was allocated to a particular type of income. Finally, we reject respondent's attempt to distinguish *Fujitsu*. The dividends in this case, to the extent not eliminated under section 25106, will be deducted under section 24402 only by virtue of the backward-looking remedy from the *Farmer Bros.* decision; were it not for *Farmer Bros.*, the dividends would be deducted under the plain language of section 24411. We do not believe the *Farmer Bros.* remedy makes the *Fujitsu* analysis any less applicable.[14]

Given our conclusion that regulation 24402, regulation 24411, *Safeway*, and *Fujitsu* are each applicable to the issue at hand, we find ourselves presented with conflicting authorities. Regulation 24402, regulation 24411, and *Safeway* all require prorating, while *Fujitsu* requires preferential ordering. After careful consideration, we hold that dividends paid from a mix of included and excluded earnings should be prorated. This holding is consistent with the weight of authority, follows the opinion of the California Supreme Court, respects longstanding administrative practice, and has a sound basis in policy and theory.

The weight of authority, including two regulations and one opinion of the California Supreme Court, points to prorating. It is important to note that *Fujitsu* never purported to invalidate regulations 24402 or 24411. As such, we are faced with two valid regulations that unambiguously

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[13] Section 25106 was actually enacted in 1967, three years prior to the decision in *Safeway*. However, section 25106 did not apply to the years at issue in *Safeway* and the Court acknowledged that its holding (regarding the elimination of dividends paid from included income) would be different under section 25106. (*Safeway, supra*, 3 Cal.3d at p. 752, fn. 7.)

[14] Appellant argues that respondent has taken an inconsistent position by attempting to distinguish *Fujitsu*, yet still apply regulation 24411. Regardless of any inconsistency in respondent's position, we are taking a consistent position here: for the reasons discussed above, we find that both *Fujitsu* and regulation 24411 are applicable.

require prorating.[15] We also note that *Safeway* was decided by a higher court than *Fujitsu*, and *Safeway* unambiguously endorsed the use of prorating. Simply put, *Fujitsu* is not the lone authority that addresses the issue at hand, but it is the lone authority to require preferential ordering. By holding that prorating is the proper method to allocate dividends between included and excluded income, we are applying two valid regulations and following the reasoning of a higher court.

Respondent's consistent, longstanding administrative practice is to prorate dividends that are paid from mixed earnings. California courts "accord significant weight and respect to a longstanding statutory construction – whether in the form of a policy or a rule – by the agency charged with enforcement of the statute." (*Ordlock v. Franchise Tax Board* (2006) 38 Cal.4th 897, 910.) Factors that weigh in favor of deference to an administrative interpretation include: the agency has expertise in a technical, complex subject matter; the agency's interpretation has been consistent; and, the agency has adopted a formal regulation embodying the agency's interpretation. (*Yamaha v. State Board of Equalization* (1998) 19 Cal.4th 1, 12-13.) The Legislature is presumed to be aware of longstanding administrative practice and its failure to enact change is evidence that the administrative practice is consistent with legislative intent. (*Id.*, at pp. 21-22 (conc. opn. of Mosk, J.), citing *Moore v. California State Bd. of Accountancy* (1992) 2 Cal.4th 999,1017-1018 and *Rizzo v. Board of Trustees* (1994) 27 Cal.App.4th 853, 862.) With respect to the present issue, the law is technical and complex, respondent has consistently applied prorating for over a half century, it has promulgated two formal regulations that embody its position, and the Legislature has not attempted to intervene. All of these factors weigh in favor of respecting respondent's longstanding administrative practice, and our holding does so.

Finally, we believe our holding is based in sound theory and policy. The reality is that the dividends at issue in this appeal are not directly traceable to either included or excluded income – they are paid from a single pool of income to which a mathematical ratio (that is unrelated to the amount

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[15] We find no merit in appellant's argument that section 24411 sets forth a preferential ordering rule that would invalidate the regulatory prorating rule. The language in section 24411 stating that a dividend is deductible thereunder "to the extent not otherwise allowed as a deduction or eliminated from income" simply ensures that a dividend is not deducted twice under two different statutes. For example, many dividends will qualify under for elimination/deduction under the plain language of both sections 25106 and 24411. The quoted language in section 24411 clarifies that, if a dividend is eligible for section 25106 elimination, then it should be eliminated from income and it is not also deductible under section 24411. Nowhere does section 24411 address the method for determining whether a dividend was paid from included income (i.e., eligible for section 25106 elimination) in the first place.

of dividends paid) is applied as a function of tax law. Prorating recognizes this reality and allocates dividends to included and excluded income in the same proportion that those types of income bear to total income. There is no practical or theoretical reason to assume that the dividends are paid primarily from included income or, for that matter, primarily from excluded income. Yet that is exactly the sort of assumption that preferential ordering requires. Preferential ordering allows the taxpayer to "have its cake and eat it, too" by receiving the benefit of excluding a portion of the subsidiary's income from the water's-edge combined report and the benefit of disproportionate section 25106 elimination. Just as LIFO ordering deters abuse by preventing the issuing corporation from declaring what year's earnings are being distributed, prorating deters abuse by preventing the issuing corporation from declaring what kind of earnings are being distributed.[16] In sum, when dividends are paid from a pool of partially included income, prorating is the most logical method for allocating those dividends among included and excluded income.

VI. Conclusion

For the reasons set forth in this opinion, we conclude that, to the extent a CFC pays dividends from accumulated earnings, those dividends are deemed paid from the current year's earnings until those earnings are exhausted, and thereafter from the most recent years' earnings, exhausting each year's earnings in turn. We further conclude that, to the extent a CFC pays dividends from a year in which it is partially included in the water's-edge combined report, those dividends are deemed paid from included income and excluded income in the ratio that included and excluded income bear to total income.

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[16] We understand and share the *Fujitsu* court's concern with preventing the double taxation of included income. (See *Fujitsu*, *supra*, 120 Cal.App.4th at pp. 477 - 480.) However, we believe that preferential ordering does not simply prevent the double taxation of included income, it also allows the avoidance of taxation on excluded income. As we discussed, preferential ordering makes an assumption – that dividends are paid primarily from included income – for which there is no practical or theoretical basis, and allowing taxpayers to declare dividends as paid from included income would open the door to abuse. Prorating allocates a proportionate share of the dividends to included income, thereby preventing double taxation, and allocates a proportionate share to excluded income, thereby preventing tax avoidance. Thus, in addition to being supported by the weight of authority, prorating also satisfies the *Fujitsu* court's concern with preventing double taxation, but without the disadvantage of allowing tax avoidance.

ORDER

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Apple Computer, Inc. against a proposed assessment of additional franchise tax in the amount of $1,258,506 for the year ended September 30, 1989, be and the same is hereby modified to reflect the Franchise Tax Board's concessions in light of *Farmer Bros.* and *Fujitsu*, but in all other respects the action is sustained.

Done at Sacramento, California, this 20th day of November, 2006, by the State Board of Equalization, with Board Members Ms. Yee*, Mr. Leonard, and Mr. Parrish present, and with Mr. Chiang and Ms. Mandel** not participating.

______________________________, Chairman

* Betty Yee ______________, Member

Bill Leonard ______________, Member

Claude Parrish ______________, Member

______________________________, Member

*Acting Board Member, 1st District

**For Steve Wesley per Government Code section 7.9.